

March 3, 2010

TO: Environmental Quality Council (EQC) Members and Staff

FROM: Montana State Leaseholders Association

RE: EQC Consideration of Cabinsite Lease Program and Legal Analysis of Full Market Value

Thank you for your oversight and discussions regarding the Cabinsite Lease Program. We felt the need to respond to a few points raised in Mr. Everts' Legal Analysis. Since Mr. Everts based his analysis, in part, on the DNRC's September 2009 report, we would like to make sure you have a balanced perspective, so we are providing copies of the recent Idaho Policy Analysis Group Report which addresses full appraisal standards for state lease land. This report is a comprehensive study of the factors that must be considered in appraising leased land and setting legitimate and sustainable lease fees. **We would also like to express our support, as outlined at the end of this memo, for the proposed action by the Environmental Quality Council.**

Full Market Value

As you know, at the heart of this issue is legal language that prescribes the Trust's income generation requirements and defines "full market value" and the methodology used to assign it.

"...administer this trust to secure the largest measure of legitimate and reasonable advantage to the state and provide for the long term financial support of education." MCA 77-1-106

"Full market value: the most probable price in terms of money that a property will bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and the seller each acting prudently, knowledgeably, and assuming the price is not affected by undue stimulus."
ARM 36.25.102

Both current rule and Alternative 3B propose rate structures that are neither *legitimate*, since they do not meet fair valuation standards or the definition of full market value, nor *reasonable*, due to the tremendous fee increases they dictate. Mr. Everts' focus on Montana's legal definition of full market value is powerful evidence that drives home our position. This definition is framed from the perspective of the "buyer" (renter, in this case) and what a prudent, knowledgeable buyer will pay. Both the current and proposed Cabinsite valuation methods are focused purely on the "seller" setting the price, with no relation to a prudent buyer.

It is important to note that, though the DNRC may maintain a need to assign a fee simple valuation, this cannot reasonably be equated as the value to the buyer. These two values are NOT the same. The DNRC's insistence that the value not be affected by lease restrictions, as quoted on page 19 of Mr. Everts' report, continues to confuse the issue. If the state were in the business of selling these properties, then the appraised fee simple comparable value would be appropriate. However, it is not selling the property, so using this method to assign lease value misses the point.

The presumption that a full market rental value is directly tied to fee simple value, as Mr. Everts presents on page 2, illustrates the faulty logic the current Cabinsite Rules are based upon, logic that is not corrected under Alternative 3B. Though certainly there is a correlation – reasonable renters will pay much higher rents for more attractive locations, and already do – the relationship between these two values is not directly proportional. Studies prove that rental rates do not hold constant

when compared to the fee simple value of property. Principles of price elasticity dictate that, as the price of any commodity goes up, fewer and fewer are willing to purchase, so the rental rate on higher value properties is actually lower than that on lower value properties. This is why the MSLA does not support any type of flat rate equation to set fees – only a system that assigns fees to properties based on their amenities as well as local market factors will meet the definition of full market value.

The full market value definition also stipulates a "*price not affected by undue stimulus*." Current rule and Alternative 3B incorporate a significant "*undue stimulus*" in that renters' improvements are, in effect, held hostage. These fee structures force renters to pay excessive fees, far beyond full market value, to preserve their financial investment in improvements. A true full market value approach would be set by the real estate rental market and would fluctuate, both up and down, not as prescribed by current rule or Alternative 3B. (We would here like to note a correction to page 6 of Mr. Everts' report, which cites that lease rent would increase *or decrease* annually – the new rule requires annual increases but *prohibits any decrease*, regardless of real estate market activity.)

We know that Department of Revenue appraisal practice is being questioned on a number of fronts. We maintain that property values and full market rents in many areas of Montana are now so divergent that fee simple appraisals are **no longer an accurate proxy** to establish full market rents. Rental rate studies concentrate on actual rents; when considering full market value, it is the actual rent that must be considered. These studies must also be kept current, based on the wild fluctuation in both fee simple property values and market rents. The 17-year-old Duffield Study is no longer relevant and reports that continue to cite it are out of step with current market factors. Similarly, the Montrust economic analysis in the 1980s only established that the values *at that time* did not match full market rental returns. Today's market and lease fees are entirely different and a current, objective analysis must be used.

Lessee Rights, Responsibilities and Restrictions

We appreciate Mr. Everts' analysis of lessee rights starting on page 16, but his analysis does not go far enough. A fair treatment would not only focus on lessee rights, but on their responsibilities and restrictions as well. As lessees, we have most of the responsibilities, but none of the protections, afforded private property owners. Our investment in improvements is completely vulnerable to lease conditions, as is now being dramatically proven. Restrictions on our use of the property, including everything from lengthy approval requirements to extraordinary building standards, are not properly considered. For instance, Mr. Everts report intimates that we have the right to sublease but says nothing of all the limits placed on that right, from the number of parties we can sublease to (only one per year) to the amount of money we can generate. This last point is particularly contentious, as it stipulates that total sublease income cannot exceed primary lease fees, completely disregarding the value of the improvement in the equation as if the sublessee were contracting only for a piece of unimproved land rather than the occupancy of a dwelling.

It is in the consideration of our responsibilities for the property that this argument gains momentum. Simply stating that a reduced rental rate reflects the cost of these responsibilities, as the DNRC and Mr. Everts does on page 17, does **not make it so**. These responsibilities run the gamut from road building and maintenance to weed suppression and fire control. A simple example illustrates the lack of justification for the DNRC's position. When a leaseholder wishes to cut a tree, permission must be received and, since that tree is owned by the state, the leaseholder must purchase it.

However, when a tree (or an entire forest) is infected with pine beetles, that tree **suddenly becomes the responsibility of the leaseholder** who must pay thousands of dollars to eradicate the pest.

The argument reaches its peak when considering the vulnerability of the lessees' improvements. These improvements are fully owned by the lessee, as established in both contract and law and referenced by Mr. Everts on page 13. However, lease conditions and fees dramatically affect their value. We know for a fact that lease fees in many areas have now surpassed what any reasonable, prudent renter would pay and have completely devastated the real estate market for improvements. Not only will this impact lessees, who are not able to find buyers for their improvements due to excessive fees, but it will also impact trust revenue and the local tax base when lessees begin to abandon their leases.

Scenarios

Mr. Everts description of scenarios starting on page 17 was both instructive and entertaining, but each new scenario strays farther from the issue at hand. We offer two additional scenarios that are more to the point:

Scenario 6: Cousins Darla and Darleen want to rent property on Flathead Lake. They approach Darryl A and Darryl B with an offer – remove your mobile homes and let us rent your property. Both Darryls agree, but each has a different expectation of what his property is worth to the girl cousins. Darryl A decides to charge 5% of the fee simple appraisal, which factors out to \$42,000 per year. Darryl B decides to conduct an open bid and advertises in the local newspaper. Both Cousin Darla and Cousin Darleen feel that Darryl A's price is too steep and decide to put in bids for Darryl B's property, along with several unrelated parties. Cousin Darla wins the bid by paying the highest rent established by the market, considerably less than \$42,000 per year, and moves her mobile home onto her new rental property. She and Darryl B are very happy!

*Scenario 7: Cousin Darleen considers her options. She could rent Darryl A's property for his asking price of \$42,000 per year or she could use her money more wisely to purchase a piece of property herself. Though she cannot afford property on Flathead Lake, there are other nice lakes nearby that she *can* afford and she decides to purchase one of those properties instead of renting. She uses her \$42,000 as a down payment on her new lot and her annual mortgage payments will only be \$15,000 per year. She is very happy! Darryl A has not found a renter, so he is not happy, though he does still have his property to console him.*

Solutions

The Environmental Quality Council and the legislature can affect a solution to the current instability of the Cabinsite Lease Program. Though the DNRC attempts to assert for itself new legal authority to determine full market value in the new rules, that power rests solely with the legislature. Mr. Everts presents several possible approaches for assessing lease market value (page 19) that warrant further discussion – some represent actual market approaches and others utilize proxies to establish lease value.

- ◆ **Approach 1**, competitive bid process, and **Approach 2**, rental market assessment process, both derive their resulting values directly from the market. Either approach would meet the Constitutional requirement of full market value and would be considered fair by the lessees.
- ◆ **Approach 3**, fee simple appraisal, represents current and proposed rule and is only a proxy for establishing fair market lease value. As we now know, this proxy gets farther and farther from

true fair market lease value the higher the property value goes. The lessees maintain this method is no longer a valid proxy and does not meet the fair market value standard.

- ♦ **Approach 4**, combining rent assessment with fee simple appraisal, uses both a direct market and proxy approach. However, due to the undue influence of the invalid fee simple proxy, it is suspect. Considerable parameters would need to be placed on this equation before it would be acceptable to the lessees.
- ♦ **Approach 5** is a novel attempt to utilize a direct market approach, albeit complicated. In the current climate of suppressed real estate market activity, it may be difficult to implement. Still, it is worthy of lessee consideration.

Proposal to the Environmental Quality Council

The Montana State Leaseholders Association is in full support of Senator Tutvedt, other members of the EQC, and other Montana legislators working to correct the critical situation threatening the Cabinsite Lease Program. We call for your action on the following three points:

1. Establish a **fair market valuation system** that meets the legal definition by specifying "fair market rental value" in current Montana code and rule and changing the language that refers to a methodology based on the Department of Revenue (fee simple) appraisal. Current statute and rule language is inconsistent, using the terms "fair market value", "full market value" and "full market rental rate" interchangeably. This language needs to be made consistent by amending the affected statutes and rules, through new legislation, to read "fair market rental value." This may also require, depending on the methodology selected, a market rent assessment or other strategies that would require outside expertise. The lessees are willing to consider covering some of those costs to establish the process. Ultimately, this will require legislative action.
2. Recognize the full **lessee bundle of rights and responsibilities** in the new valuation process. Our requests are simple and fair: in addition to a **fair valuation process**, all we are really asking for is **lease fee predictability**, **longer lease terms** to facilitate financing, and **protection for the value of our improvements** to allow us to sell those improvements for what they are worth without interference from the state. Other conditions, like removing some limitations on subleasing rights, would also be appreciated, but the three conditions above are our "bottom line." It is important to note that all three conditions, if implemented, actually increase the market value of the lease and would, therefore, increase Trust revenue. We believe that the beneficiaries, when encouraged to understand this relationship, will be in agreement that these conditions can be met.
3. Establish a **stakeholder study group to consider valuation methodology** and lease conditions affecting valuation to reach a long-term solution for the benefit of both lessees and the Trust. We have always believed there is common ground between our position and that of the beneficiaries. As we move forward with legislative change, if the stakeholders can agree on the spirit of a bipartisan bill, there should be very little opposition. The EQC should sanction such a study group and invite all the stakeholders to the table in the drafting of legislation. The lessees have long been eager for such an opportunity and will work closely with the EQC and the DNRC to support such an effort.

Thank you for allowing us to share our views and support Senator Tutvedt's proposal for EQC action.